Dependent Care Spending Assistance Account

A Dependent Care Spending Assistance Account Plan (DCAP) is an account set up by an employer that allows an employee to pay for dependent care expenses with pre-tax dollars. The employer also receives tax benefits from such an account.

How Does It Work?

A DCAP is one type of flexible spending account in which an employee sets aside a certain amount of pre-tax dollars, usually in the form of a salary reduction plan, each month to pay for dependent care. Such an arrangement allows the employee to avoid paying income and FICA taxes on the amount used for dependent care assistance. Employers receive a tax advantage as well and do not have to pay Social Security, federal employment, and most state and local payroll taxes on the amounts provided for dependent care.

After the employee accumulates dependent care expenses, they submit receipts for these expenses to the dependent care account. The account then reimburses the employee up to a maximum of $5,000 per year for these expenses. This payment is not subject to either income or FICA tax because it is technically a benefit, not compensation. The employee cannot receive payment for any expenses that are more than the amount they have set aside in the dependent care account. Unused set-aside amounts in the account are lost.

A salary-reduction DCAP can be offered alone or as part of a flexible benefit program under which employees have more than one benefit option.

What are the Requirements for the Employer?

A DCAP offered under a salary reduction plan must meet the requirements of Sections 125 and 129 of the Internal Revenue Code.

1. The employer must formally sponsor the DCAP. This requires a written document that satisfies Section 129 of the Internal Revenue Code.

2. The employer must obtain a signed authorization from the employee before each plan year begins that specifies a fixed contribution amount.

3. The employer must report the amount of dependent care expenses in a special box on the employee's W-2 form.

The Internal Revenue Code also requires that plan benefits do not discriminate in favor of highly compensated employees or their dependents. The average benefit for lower- paid employees must be at least 55 percent of the average benefit for highly compensated employees. The maximum set aside for a family is $5,000 per year, or $2,500 for each parent if a married couple is filing separate tax returns.

What are the Requirements for the Employee?

1. The dependent care account must be accumulated during the plan year in which the employee contributes to the DCAP. Old expenses are not allowed, and leftover account balances cannot be carried forward and used in the future.

2. Dependent care expenses can only be reimbursed if they were incurred to allow both the employee and his/her spouse to work.

3. Dependent care expenses are only reimbursable if they are for dependent children up to age 13 or for disabled children who live with the employee.

4. In order to be reimbursed, the employee must submit a receipt for all expenses, including the tax identification number of the dependent care provider.

Generally, the DCAP will provide greater tax savings to those employees whose income exceeds $25,000. Employees with income below $25,000 will realize greater tax savings through the federal child care tax credit. Employees can use both the dependent care account and the federal tax credit if dependent care expenses claimed total less than $4,800. The amount received from a DCAP reduces the available tax credit by the same amount. For example, if you put $3,000 into a DCAP at the beginning of the year, but accumulated $4,800 in child care expenses, you could claim the $1,800 difference as a tax credit.

Benefits of a DCAP

- Assists employees with a wide range of dependent care needs;

- Tax advantages to both the employee and the employer;

- Simple administration through payroll deduction; and

- Gives employees flexibility.

Considerations of a DCAP

- Unused set aside is lost; and

- DCAPs generally do not benefit employees with annual incomes of $25,000 or less, because these employees often cannot afford to set aside any of their gross or net earnings.